ORIGINAL

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of Sections of	)	
The Cable Television Consumer	)	**MM Dkt. No. 92-266**
Protection and Competition Act	)	
of 1992	)	
	)	
Rate Regulation	)	

COMMENTS OF JOINT PARTIES

Cablevision Industries Corporation
Comcast Corporation
Cox Cable Communications,
a division of Cox Communications, Inc.
First Carolina Communications, Inc.
Jones Intercable, Inc.
Marcus Cable Company, L.P.
Sonic Communications
Summit Communications Group, Inc.
US Cable Corporation
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TABLE OF CONTENTS

SUMMARY

In its Third Further Notice of Proposed Rulemaking on Rate Regulation, the Commission is appropriately seeking a simplified benchmark-related approach to adjusting the permitted per-channel rate for basic and cable programming services when a cable system adds channels to its regulated tiers. The specific formula proposed by the Commission, however, does not sufficiently take into account the costs of adding channels. Several adjustments should be made to assure that operators recover a reasonable profit after adding channels.

The Commission has also proposed a unitary approach to justifying basic and non-basic rates that would require cable systems to use the same method — benchmarks or cost-of-service — for all regulated tiers. This approach would impose severe costs, burdens and practical difficulties and serves no public policy purpose.

Methodology for Adding and Deleting Channels. A properly designed formula for adjusting rates when channels are added will relieve operators of the need to engage in full cost-of-service showings for adjusting programming offerings on regulated tiers of service. Though the methodology proposed by the Commission is a good starting point, some adjustments are necessary to enable operators to recover a reasonable profit and to provide incentives to add new channels.

The Commission's formula would, in effect, send systems that add channels back to the benchmark tables and reduce maximum allowable per-channel rates

by the percentage difference between the benchmark rate for the initial number of channels and the benchmark rate for the new number of channels. But this approach fails to recognize that systems that add channels incur significant costs and thus do not realize the same efficiencies as initially built systems with the same total number of channels at the outset. Thus, the large percentage decline in benchmark rates as channels are added needs to be reduced if systems are to be able to add channels and recover a reasonable profit.

First, the Commission's formula should include a percentage upgrade adjustment to take into account the costs of adding new channels.

Second, the Commission's downward per-channel rate adjustment should be applied only to the added channels, or, at most, only to the tier to which these channels are added. This approach would accomplish the necessary objective of reducing the percentage decline in allowable rates when channels are added and would also counter the risk of reduced penetration on the tier affected by the channel addition.

Finally, while the Commission's proposal properly exempts programming costs from any supposed "efficiency adjustment" when channels are added to a system, it fails to exempt the profits that are earned on programming. Both existing programming costs and a profit on those costs must be removed from the permitted rate before adjusting the rate down by the efficiency factor. New programming costs and a profit on those costs must be added back after the adjustment is made.

Approaches to Justifying Regulated Service Rates. The Commission should permit operators to select different approaches to justifying rates for basic and non-basic services. Any perceived "gaming" problem would be eliminated if the Commission, in conducting a cost-of-service review of cable programming rates, took into account the rates and costs associated with the basic service tier. Permitting operators to rely on benchmarks on the basic tier and cost-of-service on the non-basic tiers would reduce the administrative burdens on cable operators and local franchising authorities who would otherwise be forced to conduct a cost-of-servicing proceeding to review basic service rates. There is no reason to require such duplicative proceedings, and indeed, no practical way to implement such requirements.

Adjusting Rates for Systems That Were Recently Upgraded. The Commission should permit operators that recently upgraded their systems to adjust rates according to the scheme adopted for systems that add channels in the future. The Commission should permit such operators to raise their pre-upgrade rate to permitted levels if rates are below permitted levels, and then adjust those rates by the channel addition formula. This approach would compensate operators that have recently upgraded for the costs incurred in upgrading and offset the steep and unwarranted decline in benchmark rates that would otherwise be required.

Upgrades Required by Franchising Authorities. The Commission correctly notes that treating the costs of upgrades required by franchising authorities as

external costs would be consistent with the approach of permitting operators to pass-through the costs of franchise obligations. As these costs are beyond the control of cable operators, they should be afforded external cost treatment.

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COMMENTS

The parties listed in the attached Exhibit A (the "Joint Parties"), by their attorneys, hereby submit their comments on the Commission's Third Further Notice of Proposed Rulemaking in the above-captioned proceeding.[1/]

INTRODUCTION

In its Third Notice, the Commission addresses several issues left unresolved or ambiguous by its rules that implement the rate regulation provisions of the Cable Television Consumer Protection and Competition Act of 1992.[2/] Most of the issues are concerned with ensuring that the Commission's benchmark approach yields rates that enable cable operators that have upgraded their systems

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1/ Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, Third Further Notice of Proposed Rulemaking, MM Dkt. 92-266, FCC 93-428 (released August 27, 1993) ("Third Notice").

2/ P.L. 102-385, 106 Stat. 1460 (1992) (the "1992 Cable Act").

and added channels of programming to their regulated tiers to fully recover their costs plus a reasonable profit. The Commission's proposed methods of dealing with this problem need to be modified if they are to ensure that operators have appropriate incentives to invest in upgrades and channel additions.

The Commission also proposes to interpret its rules to require that cable operators must justify both their basic rates and their rates of cable programming services on the same basis — either relying on benchmarks or cost-of-service for both tiers. As Joint Parties demonstrate, however, no purpose is served by forcing a system that opts for cost-of-service on one tier to subject itself and regulators to the burdens and costs of a second cost-of-service proceeding with respect to the other tier, even if that tier's rates are at or below benchmark levels.

I. The Commission's Proposed Formula Must be Modified to Provide Operators Reasonable Incentives to Add Channels To Existing Systems.

The Commission's rate regulations are ambiguous as to how a system's maximum permissible rates are affected when channels are subsequently added to regulated tiers. A system's initial permitted rate is determined from the benchmark table or from its September 30, 1992, rate less 10 percent. Benchmark rates depend, in part, on the total number of channels and the number of satellite services on a system. Once initial rates have been determined, future increases are subject to price caps based on (1) the rate of inflation, as measured by the

GNP-PI and (2) pass-throughs of certain "external costs," including any increases in the cost of programming to the extent that such costs exceed inflation.

If a system adds new channels of programming, is it supposed to go back to the benchmark tables and find a new benchmark based on the increased number of channels? Or, once initial rates have been established, is the system subject to the price cap, so that it may retain the existing per-channel rate and pass-through the increased costs of the programming that appear on the added channel?

The Commission proposes an approach that sends systems that add channels back to the benchmark tables to obtain a new maximum allowable rate based on the new number of channels, but also allows them, in effect, to pass-through any increases in their per-channel programming costs that result from the upgrade or rebuild. But this approach does not adequately ensure that operators will recoup the costs of adding new channels to their systems, much less a reasonable profit on the additional investment.

The problem with simply returning to the benchmark tables is that benchmark rates in those tables — which reflect the average rates charged by systems with a particular number of channels and satellite services adjusted downward by 10 percent — do not adequately reflect the costs incurred in adding channels. Benchmark rates decline precipitously as the number of channels increase, reflecting a supposed general increase in per-channel efficiency. But systems that have recently increased their channel capacity incur costs that more

than offset any increased operating efficiencies. Their per-channel costs are higher than those of the average system that had a comparable number of channels on September 30, 1992 — the date on which the Commission's survey of benchmark rates was based.[3/] In other words, a system that adds 20 channels to an existing 25-channel system, or a system that adds five channels to an existing 40-channel system will face higher costs and realize fewer efficiencies than a system that initially built a 45-channel system. The former system incurs a second round of substantial costs not incurred by the latter.[4/] Moreover, unlike existing 45-channel systems, upgraded systems must decide whether to activate or upgrade to 45 channels — and they will have no incentive to do so if the marginal permitted revenue will not cover expected costs plus a reasonable profit.

The Commission's proposed approach does not adequately reflect the fact that systems that add new channels of programming incur higher costs than the average benchmark system reflects. The Commission's formula recognizes that

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3/ That survey, of course, was based only on rates not costs.

4/ Indeed, certain increases in costs incurred in upgrading actually may reflect a decrease in efficiency. During a recent upgrade, one cable system upgraded from 330 MHz to 550 MHz. Though channel capacity increased 66 percent, total electricity usage cost increased 150 percent. The per subscriber cost of electricity increased to $0.50 per subscriber per month from $0.20 per subscriber per month. This demonstrates that generally, there is no guarantee that the addition of channels will result in efficiencies in all cost-based variables. Thus, the Commission should not assume that the slope in the benchmark formula accurately reflects efficiencies in all costs.

programming costs should not be subject to any downward efficiency adjustment[5/] when a system adds new channels. Accordingly, total programming costs prior to adding channels are subtracted from a system's initial maximum permitted rate before the downward efficiency adjustment is applied, and the new total programming costs are added back after the adjustment to obtain the new maximum permitted rate.

While the proposed formula recognizes the absence of efficiencies that result if the per-channel programming costs decreased as more channels are added to a system, it does not in any way deal with the other costs incurred by a system that has recently added new channels. Further adjustments and modifications to the Commission's approach are necessary to provide operators with incentives to add channels without having to incur the costs, burdens and unpredictability of cost-of-service proceedings.

Specifically, the Commission should recognize the fact that the efficiency adjustment embodied in the benchmark tables is excessive when applied to systems adding channels by:

(1) including in its formula an upgrade adjustment factor that offsets the efficiency adjustment;

(2) requiring systems that add channels to apply the new, lower per-channel rate derived from the formula only

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5/ The efficiency adjustment is calculated, under the formula, as the percentage difference between the benchmark rate for the initial number of channels and the benchmark rate for the new number of channels.

to the newly added channels — or, at most, to the tiers to which the channels have been added; and

(3) exempting from the efficiency adjustment not only all costs of programming but a reasonable profit on such costs.

A. The Commission's Formula Should Include an Adjustment for the Costs of Adding Channels.

The most direct way to account for the differences between the costs of the average system with a particular number of channels (as embodied in the benchmarks) and the costs of systems that have recently added channels to reach the same number of channels would be to incorporate an upgrade adjustment into the Commission's proposed formula. Because the efficiency adjustment in the formula — the percentage difference between the benchmark rates for the original and the new number of channels — appears to be too high because of the above-average costs incurred by systems that upgrade their facilities to add additional channels of programming, the Commission must decrease the efficiency adjustment.

The Commission has indicated its willingness to "explore the feasibility of modifying the benchmark to include an upgrade variable."[6/] As the Commission concedes, its current benchmarks do not include such a variable and therefore do

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6/ Third Notice at 88 n.259. The Commission recognizes the necessity that an operator that upgrades be able to recoup the costs of the upgrade. Third Notice at ¶ 145.

not take into account the differences between systems that have recently upgraded and those that have not.[7/]

It may be that, as the Commission suggests, it would be "very difficult to fashion a variable to the benchmarks to govern rates when channels are not added or deleted."[8/] Even if it would be difficult to run new regression analyses with an upgrade variable in the benchmark formula, it still would be desirable at least to modify the Commission's proposed formula to incorporate some reduction in the downward efficiency adjustment when a system adds new channels.

Determining the precise extent to which the efficiency adjustment should be reduced to account for the cost of upgrades may be difficult because, as the Commission recognizes, "the cost of upgrades will vary for each operator depending on the extent and quality of the upgrade."[9/] But while the precise level of the adjustment may be uncertain, one thing that is certain is that there must be some adjustment. An efficiency adjustment based solely on the percentage difference between benchmark rates for the old and new number of channels will neither ensure recovery of upgrade costs nor provide sufficient incentives for operators to upgrade or otherwise add new channels of programming to regulated tiers.

7/ Third Notice at 88 n.259.

8/ Id. (emphasis added).

9/ Id.

B. The Proposed Formula Should Apply Only to the Channels that Are Added Or, at Most, to the Tiers to Which the Channels are Added.

Whatever formula the Commission adopts should be applied only to rates charged for the newly added channels — or, at most, to the tiers to which the channels are added. Under such an approach, if a system added ten channels to a tier of cable programming services, the permitted per-channel rate for those channels or for that tier would be reduced in accordance with the formula, but the rates for the basic tier and other unaffected tiers would remain at the current permitted rate.

This method would help to offset the failure of the benchmark rates to take into account appropriate costs of adding channels. Moreover, there are no sound analytical and policy reasons to require a reduction in per-channel rates for all tiers when services are added only to one tier. Specifically, the fact that channels are added to a system does not guarantee that revenues will increase. Though overall rates increase, subscriber penetration on the affected tier may be reduced. In such circumstances, there is no reason why allowable per-channel revenues from other tiers should be reduced. Suppose, for example, that a system adds 20 channels to an existing tier of cable programming services or creates a new 20-channel tier of such service. In the case of the new tier of service, it may be that only a small number of subscribers choose to buy this newly created tier. In the case of adding channels to an existing tier, most subscribers may retain

basic-only service or downgrade to the basic tier to avoid paying the added charge. Thus, a reduction in the rates for the basic tier could result in an overall net reduction in revenues, even though the new tier has provided a new and desirable option for some subscribers. If this occurs there would, of course, be no incentive to add services to optional tiers, and the Commission's formula would not allow operators to charge a reasonable rate for the basic tier.

Finally, there is no reason why the addition or deletion of channels on optional tiers should be required to trigger changes in rates of subscribers who do not purchase such tiers. There is no reason, for example, why basic-only subscribers should receive a rate decrease when channels are added to a tier that may be purchased by only a portion of the system's subscribers — and no reason why basic subscribers should face a rate increase when such channels are deleted.

C. The Commission's Proposed Formula Should Be Modified So That Allowable Profit Margins on Programming Are Not Reduced When Channels Are Added.

To the extent that there are increased efficiencies when a system adds channels, the Commission has appropriately recognized that those efficiencies are not realized in the cost of the new programming provided over those channels. In other words, the per-channel cost of programming does not decrease when channels are added. Therefore, the Commission's formula effectively exempts programming costs from the downward efficiency adjustment that is applied to existing rates when channels are added. The formula removes total programming

costs from the initial rate charged by systems for the original total number of channels, and adds back the total cost of programming for the new number of channels after the efficiency adjustment has been applied.

But this approach does not fully reflect the fact that there are no programming efficiencies when a system adds channels. The Commission's benchmarks are intended to reflect "competitive" rates — i.e., rates that cover a system's costs plus a reasonable profit. The Commission's proposed formula properly exempts programming costs from the efficiency adjustment, but does not exempt the profits on such programming that are built into the benchmark rates. Thus, the formula inappropriately and unintentionally reduces the profit that a system is entitled to recover on its programming to a level below what previously had been allowed as reasonable. The effect is that profit margins on programming will be eroded as new programming is added, thus removing incentives to add such programming.

To correct this problem, the Commission's formula should be adjusted to exempt not only programming costs but also a reasonable profit on such programming from the efficiency adjustment. When initial programming costs are removed from the initial rate charged by the system, and when total programming costs are subsequently added back to the reduced maximum allowable rate, a reasonable percentage profit on such costs should also be removed and added

back. Otherwise, the new maximum permitted rate would embody a wholly unwarranted reduction in the allowable profit on the sale of programming.

II. The Commission Should Allow Operators Discretion to Select the Benchmark or Cost-of-Service Approach For Any Regulated Tier of Service.

The Commission proposes to require operators to use the same rate-setting method for all regulated service tiers in order to maintain a tier neutral regulatory framework[10/] and to avoid "gaming" by cable operators in the pricing of basic services. The Commission's concerns regarding "gaming" and tier-neutrality are, however, misplaced. Allowing cable operators to opt for the benchmark scheme on one tier and cost-of-service and on another need not provide opportunities or incentives to shift programming between tiers, evade rate regulation or charge higher overall rates. If the Commission required operators to rely on the same method to justify to rates for all regulated services, operators would be burdened by the unnecessary additional costs of submitting two nearly identical cost-of-service showings. In any event, such a policy would be administratively and procedurally complex for all regulatory authorities.

The Commission's "gaming" concern is that operators would put very inexpensive programming on its basic tier and charge their permitted per-channel rate, which would be more than adequate to cover costs plus a reasonable profit.

10/ Third Notice at ¶ 146.

Meanwhile, having placed more costly programming on its non-basic tier, the operator could rely on a cost-of-service showing to justify rates on the tier with rates that exceed permitted levels. Thus, overall rates would be higher than if a cable operator had to justify both basic and non-basic rate on the basis of costs in a cost-of-service hearing, and the operator would realize a windfall.

This problem would not be exist, however, if in setting the rates for the cable programming service tier, the Commission considered the system's overall costs and rates for all regulated services, including the costs and rates of the basic service tier. In fact, under the 1992 Cable Act, the Commission has express authority to consider the rates "for all the cable programming, cable equipment, and cable services provided by the system," other than pay-per-view programming.[11/] This approach would solve the gaming problem and avoid the administrative burdens on all interested parties of conducting two cost-of-service proceedings.

The Commission's concern with tier neutrality is similarly misplaced. The Commission's policy of tier neutrality was not aimed at preserving equal per-channel rates on all tiers as an end in itself. Rather, the Commission was concerned that if basic rates were subject generally to a stricter level of scrutiny than cable programming service rates, operators would have incentives to shift all services, other than broadcast signals and access channels, to the non-basic tier.

11/ 47 U.S.C. § 543(c)(2)(D).

Doing so would result in higher total rates for basic service and cable programming services. But there is no comparable problem here. So long as the Commission, in reviewing non-basic rates in cost-of-service showings, can take into account the rates and costs of the basic tier, a cable system that opted for the benchmark on the basic tier and cost-of-service on the non-basic tier could not obtain a higher overall rate than if it had opted for a cost-of-service showing on both tiers.

In any event, requiring equal pricing of tiers and requiring operators to choose the same method to justify rates for all tiers is unworkable as a practical matter. Basic tier rate regulation and non-basic tier rate regulation not only are conducted by different regulatory authorities under different procedural frameworks; they also are conducted on completely different timetables. Basic rates are subject to review by a local franchising authority only when the authority initially certifies or when a system subsequently increases its basic rates. Rates for cable programming services are reviewable by the Commission only if a subscriber or franchising authority files a complaint.

Suppose, for example, that a system's basic and non-basic tiers are both at or below permitted levels. The system will initially be required only to justify its basic rates to the franchising authority — assuming that the franchising authority certifies — and it will do so by relying on the benchmark system. Does this forever preclude the system from subsequently raising its non-basic rates and

justifying such an increase on the basis of a cost-of-service showing? Or, if the system is permitted to justify its increased rates for non-basic service in a cost-of-service showing at the Commission, will it also be required to go back to the franchising authority and justify its basic rates in a cost-of-service showing — even though those rates have already been approved under the benchmarks?

In short, a requirement that systems consistently choose cost-of-service or benchmarks for all regulated tiers would raise a host of unanswered and unanswerable questions and could be unworkable even if there were policy reasons to require such uniformity. But, in any event, no such reasons exist.

III. Systems That Upgraded Shortly Before Congress Imposed Regulation Should Be Permitted to Adjust Rates in the Same Manner As Systems That Upgrade in the Future.

The Commission seeks comment on how to treat systems that upgraded prior to regulation but whose rates remain below benchmark levels.[12/] The Commission suggests that such systems should be permitted to raise rates to benchmark levels. Though this provides some recovery of upgrade costs, this recovery is insufficient. The same holds true for systems that were at the benchmark level after a recent upgrade. Joint Parties suggest that the Commission ensure that recently upgraded systems with rates at or below benchmark levels be permitted to recover their upgrade costs.

12/ Third Notice at ¶ 146.

There is no rationale for capping at benchmark levels the rates of systems that have recently upgraded if doing so would prevent these systems from recovering the costs of the upgrade. The Commission could simplify treatment of such systems by treating them the same as systems that intend to upgrade in the future. Both types of operators are concerned with recouping upgrade costs attributable to channel capacity and additional programming costs. In addition, both types of operators are concerned with the precipitous decrease in the per-channel rate as channels are added. Thus, for the sake of efficiency, the Commission should permit recently upgraded systems to apply the same channel addition formula for systems that upgrade in the future.

This can be accomplished by examining the recently rebuilt system prior to the rebuild. If the system prior to the rebuild had 30 channels and has added 10 channels, the Commission should permit below-benchmark rates to be increased to the benchmark level, or retain the existing permitted rate if it is at or above the benchmark level. The Commission should then apply the channel-addition formula to generate the new permitted per-channel rate after the upgrade.[13/]

13/ For example, assume a system upgraded from 30 to 40 channels shortly before rate regulation. Under rate regulation, the system would be treated as a 40 channel system and be unable to recover the costs of the upgrade. To permit recovery of these costs, the operator's permitted rate should be the maximum permitted rate at 30 channels with an adjustment for a 10 channel upgrade. This is basically the same treatment afforded a 30 channel system that intends to upgrade in the future.

The Commission also has requested information on how cable operators price after a rebuild.[14/] Generally, cable service rates do not immediately jump to the levels necessary to recover all upgrade costs. Rather, systems recoup their costs more gradually, with additional increases over several years. This method of pricing prevents a decrease in subscribership with the expectation that upgrade costs could be recovered over time. The Commission's rules make it difficult to recover upgrade costs in this manner because rate increases in any given year are limited to inflation increases under the price cap formula, even where a system's initial rates are below the maximum permissible level. Unless systems that have upgraded their facilities are to be required, annually, to resort to cost-of-service showings to justify rate increases necessary to ensure the full recovery of their upgrade costs, the Commission's benchmark and price cap scheme will need to take into account the fact that upgrade costs must be recovered in periodic rate increases, not all at once.

IV. Operators Should Be Permitted to Pass Through Costs of Upgrades Required By Local Franchising Authorities or Other Regulatory Authorities.

The Commission solicits comment on whether it should permit external cost treatment for costs of upgrades required by local franchising authorities.[15/]

14/ Third Notice at ¶ 145.

15/ Third Notice at ¶ 153.

As the Commission points out, such a rule would be consistent with the external cost treatment allowed for the costs of franchise requirements. As recognized in the Commission's Order implementing its rate regulations, the costs of satisfying franchise requirements are "largely beyond the control the cable operator."[16/] This is true regardless of the type of requirement imposed.[17/]

The Commission's concern that the pass through of such costs might undermine the benchmark structure is misplaced. Moreover, it ignores the Commission's own rationale for passing through external costs: these costs are not voluntarily assumed by operators. The body entrusted with monitoring basic cable rates in such cases has itself determined that the benefit of the rebuild to the customer justifies the increased cost.[18/]

The Commission also requests comment on other options for treating these costs if it determines that they should not be passed-through.[19/] It first proposes that such costs should be governed by the cost-of-service standards. Specific

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16/ Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, Report and Order, MM Dkt. 92-266, FCC 93-177 ¶ 254 (released May 3, 1993) ("Rate Order").

17/ Regulatory authorities other than the local franchising authority, such as state cable commissions, might in some circumstances have authority to impose upgrade requirements. The Commission should allow systems to pass-through upgrade costs imposed by any governmental body.

18/ In fact, since all upgrades presumably benefit consumers, Joint Parties suggest there is no reason not to allow all upgrade costs to be passed-through.

19/ Third Notice at ¶ 154.

problems applying cost-of-service rules in this context may not be fully apparent until the Commission promulgates its final cost-of-service regulations. The Commission has repeatedly stated, however, that it does not intend cost-of-service to be applied as a primary means of regulation. Use of cost-of-service rules in this context would require more operators to endure the complex and expensive process of such a showing and may subject the operator to additional accounting and allocation requirements. The result is an essentially mandatory cost-of-service proceeding for an operator solely due to the fact that it wishes to comply with franchise requirements.

CONCLUSION

The Commission's proposal for adjusting rates for channel additions and upgrades should be modified in the manner described herein, to permit operators to recover a reasonable profit plus the costs associated with the upgrade and to ensure there are sufficient incentives to add new channels of programming. Furthermore, the Commission should adopt its proposal to allow systems whose rates are below benchmark levels on the initial date if regulation to raise their rates to the benchmark levels if the systems upgraded shortly before the initial date of regulation. The Commission should take steps to ensure that all systems that upgrade shortly before regulation are able to raise rates to levels that allow recovery of upgrade costs. The Commission should also adopt its proposal to

treat the costs of upgrades required by local franchising authorities as external costs.

Finally, the Commission's concern that permitting operators to justify rates under a different approach for each regulated tier of service would enable systems to engage in "gaming" in order to evade regulation and charge excessive rates is unfounded. So long as the Commission can examine a system's rates and costs associated with basis service when it reviews rates for non-basic cable programming services, it can prevent any "gaming" that would result in excessive profits.

Respectfully submitted,

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